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Hungary: Major New Economic Reforms in Prospect

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An Intelligence Assessment

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An Intelligence Assessment

This paper was prepared by [redacted] Office of European Analysis. Comments and queries are welcome and may be directed to the Chief, East-West Regional Issues Branch, EURA [redacted]

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Key Judgments

Information available as of 24 May 1984 was used in this report.

Budapest this year is inaugurating the first major modernization of an economic reform program that caught worldwide attention 16 years ago with its bold breakaway from the Stalinist economic model. New measures, long in the drafting and now proposed for gradual introduction during the period 1984-90, seek even greater decentralization in enterprise management, pricing, wages, and in the use of labor, capital, and credit.

Although a broad outline for change has won party support in principle and some initial measures are being introduced this year, many of the specific and more path-breaking proposals are still under debate. Initially, the reforms will give a somewhat greater voice to managers and workers in running their enterprises and—in the case of the most efficient firms—greater freedom to set prices and wages. Measures to decentralize the banking system and to restructure the tax system probably will be among the last adopted. We do not expect decisions by the Central Committee on the specific scope and pace of reform until sometime next year.

The key question is how far the Kadar regime is willing to go. Certainly Hungary's leaders have no intention of abandoning their socialist system. We have seen nothing to suggest that the state is willing to relinquish ownership of the means of production, cede major power to workers over enterprise management, or embrace political pluralism at the national level. Moreover, the regime faces some real obstacles:

- The Hungarian people will have to be won over, since some of the reforms—at least in the short run—could lead to a decline in living standards.
- Budapest will have to contend with resistance from entrenched party and government bureaucracies.
- And, the reform proposals risk negative reactions from the new Soviet leadership and other East European regimes.

We already have seen signs that Budapest is fearful that the Western press will overplay "capitalist" aspects of the new measures and provoke criticism from Hungary's more orthodox allies. Other bloc countries are wary of the demonstration effect of Hungary's higher living standards and are concerned that its economic reforms may, in the end, lead to significant political liberalization.

Nevertheless, allowing for some scaling down or delays, it is clear that Hungary's leaders find the need for radical changes imperative and are prepared once again to go much further than their Council for Economic Mutual Assistance (CEMA) allies in the common quest for a more efficient system of economic management. As of now, it appears that the New Economic Mechanism is headed for a new watershed that promises to keep it the most innovative model for evolutionary change in Eastern Europe.

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Milestones in the Evolution of Economic Reforms

Late 1964	*Party Central Committee appoints high-level government commission to study reform of the system of economic management.*
1965-67	*Debates among specialists are followed by public discussion and some experimentation.*
1 January 1968	*New Economic Mechanism (NEM) implemented, featuring decentralization of operational decisionmaking to the enterprise level and some use of market forces.*
1971-76	*In the face of soaring trade deficits, excessive investment, and resistance to greater wage differentiation, Party hardliners succeed in recentralizing some economic controls.*
October 1977	*Central Committee, in a watershed decision, calls for reestablishing the original direction of NEM as a means of promoting enterprise efficiency, modernizing the economy's structure of production, and improving the balance-of-payments position.*
1978-80	*Economic reformers regain influence with policymakers and initiate wideranging debates over restructuring the system of economic management; initial measures introduced for greater wage differentiation and "competitive" producer prices based on world market prices.*
Early 1981	*Several subcommittees of experts appointed by Central Committee's Economic Working Group to draft a comprehensive reform concept.*
June 1982	*Central Committee approves reform proposals in principle and orders preparation of an integrated "economic policy concept" for implementation in 1984-90.*
April 1983	*Central Committee reviews 66-page report from the experts entitled* Policy Concepts: Concerning the Further Development of the Economic Management System.
April 1984	*Central Committee makes first public announcement that some proposals have been agreed upon for implementation starting in 1985 and orders work on other proposals.* [redacted] 25X1

Hungary: Major New Economic Reforms in Prospect

Introduction

Concepts for a "new phase" in economic reform have been circulating in Hungary's prolific professional think tanks since 1977 when mounting balance-of-payments difficulties forced party leaders to call for a fundamental review of economic strategy. Budapest recognized the need to revive the 1968 reforms which had been diluted during the first half of the 1970s. New rules of the game were needed to make enterprise managers more profit oriented and induce them to become entrepreneurial risk-takers in assuming the lead in updating the country's increasingly outmoded structure of production.

While Hungary has cautiously introduced some limited reforms in recent years, the country's financial crisis has focused economic policy largely on stabilization measures. Budapest has slashed investment and slowed the growth of consumption in an effort to run current account surpluses. Hungarian economists and leaders, however, recognize that these measures are only short-term fixes.

Figure 1. Austerity—Brief Briefing: Don't bother to sit down, comrades. This is just to let you know what our current economic situation permits!

Proposals now under study spring essentially from a consensus that bolder action is needed to correct problems with efficiency and competitiveness if Hungary is to enjoy economic growth and external equilibrium over the long term. In particular, the regime feels it is imperative to tackle the problems of:

- Too many large monopolistic enterprises that are protected by vested hierarchial management institutions, restricting incentives to use resources efficiently.
- Too many export products that are not price competitive in hard currency markets.
- Labor and capital that are in short supply, yet continue to be misallocated in activities with small profits or even losses.
- The easy availability of bank credit and the lack of institutions to channel it into activities yielding the highest returns.

Thus, reform proposals aim at establishing an elaborate new institutional framework that offers individual enterprises greater freedom to set prices and wages while at the same time providing inducements to use labor, capital, and credit where the potential payoffs seem greatest. These are not new ideas in Hungary, but experts commissioned by the government now see a need to reach out in directions that have no precedents. They seek solutions through a more far-reaching decentralization of decisionmaking not only to the enterprise level but within the banking system as well.

The general thrust of government proposals for new reforms is contained in two lengthy concept papers prepared primarily by economic professionals. In addition, Budapest's letter to the International Monetary Fund (IMF) last December requesting new standby credits contained a brief sketch of the proposals,

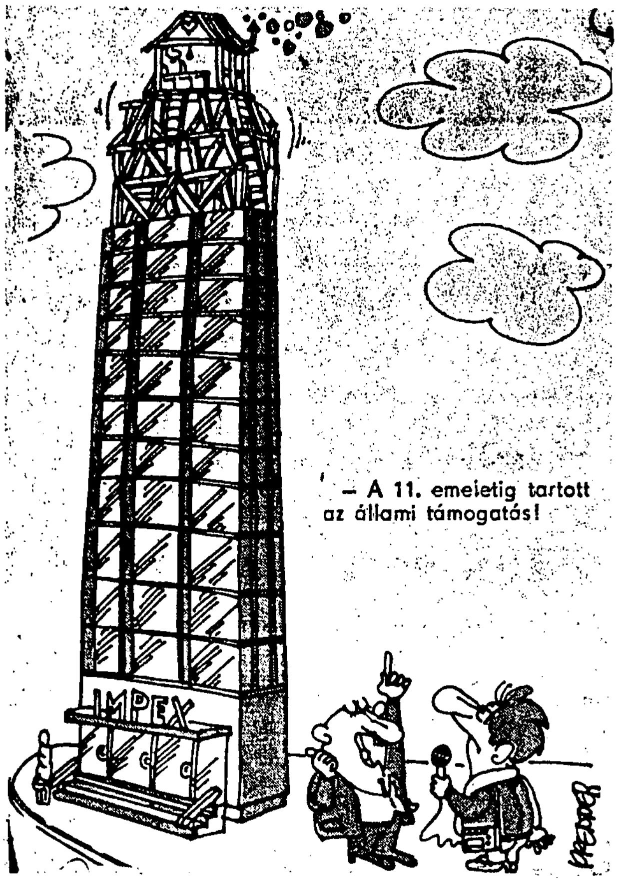

Figure 2. Investment squeeze—Government support lasted up to the 11th floor!

and a party plenum in mid-April called for reforms in "every aspect of management." Because these documents tend to be vague and elliptical, we offer here only a preliminary interpretation of what seem to be the most innovative highlights.

Enterprise Management

At the core of the new reform concepts is the notion that central or middle-level state administrative agencies should possess only general supervisory authority and should be divested of their rights to interfere in the operational and investment decisions of enterprise managers. Implementation of this concept was already evident in 1980 with the merging of three central industrial ministries into one with diminished authority, and in the subsequent breaking up into smaller units of numerous trust organizations and other very large enterprises enjoying monopolistic market positions. Organizational decentralization along these lines is to continue. 25X1

Vetoed, at least for the 1984-90 period, is the creation of "holding companies," unique types of property management agencies long advocated by many prominent reform economists. The winning argument apparently was that holding companies, for all their potential merits in separating the state from the economy, could easily become ministry-like protective organizations that would serve to restrict rather than promote the development of profit-oriented entrepreneurial attitudes on the part of their subordinate enterprises. 25X1

Reform proposals envisage a much larger number of medium and small enterprises [1] with independent rights to decide on their internal organization, planning, relations with other firms, and use of materials, labor, and capital. Several new "enterprise profiles" are suggested, depending on whether the reorganized firm is owned by the state or by a cooperative. In general, the reforms seek to create a "system of interests" in which new representational bodies allow managers and workers alike more say-so in how their firm is run and who runs it. Central authorities, however, will apparently retain a veto power over almost every aspect of management when actions conflict with their perception of national interest. Even the most ardent reformers emphasize that their proposals for decentralized decisionmaking at the enterprise level have little in common with Yugoslav self-management, which they contend has led to a spiraling of wages and prices that central authorities have been unable to contain. 25X1

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Capital and Credit Markets

Among the most innovative of the new reform proposals are those directed at making better use of new and existing fixed assets and decentralizing the credit functions of the central bank. They may also be

[1] A program for expanding the number of small enterprises is already well under way as part of an effort to legalize and tax much of Hungary's huge "second economy." See the appendix. 25X1

among the most politically sensitive because they imply closing down chronically unprofitable enterprises and reallocating not only their capital assets but also their labor forces to other enterprises—a prospect that many displaced managers and workers would find traumatic.

Reforms in these two areas are interrelated. They grew out of experiments begun in 1983 aimed ultimately at developing a Western-like capital market providing alternative types of financial assets marketable to both enterprises and the general public. What is contemplated in the years ahead goes considerably beyond the sale and trading of equity shares in domestic corporations and the issuance of government and enterprise bonds that occurred on a limited scale last year.

The new proposals would create a network of commercial banks, subject only to oversight by the central bank, that would accept and rediscount obligations of enterprises—something Hungarian bankers describe as a market for "commercial bills." In line with this, the central bank also would be empowered to adopt a "flexible interest rate policy" affecting deposits and loans of both enterprises and the public. The bank would be free to raise or lower domestic interest rates in line with shifts in the cost of obtaining foreign credit or in the real interest rate caused by domestic inflation. As far as we can tell, these proposals are still on the drawing board and are likely to be among the last acted upon. Officials of the National Bank of Hungary naturally would like a greater voice in monetary policy, but they are reluctant to assume responsibility for it without full backing from the Ministry of Finance, to which the bank is subordinate.

Pricing and Enterprise Finance

Many other changes are embodied in the new reform concepts, mostly involving proposed tax reforms and other revisions in enterprise financial flows to and from the government budget. Potentially the most important measure here is the gradual introduction of so-called quasi-free market prices into much of the economy.

Further Price Reforms. Pricing rules to be introduced on a limited basis this year but rapidly extended thereafter will greatly modify the so-called competitive price system [2] implemented in 1980. Domestic producer prices in the 1980 concept were considered competitive if they were linked to world markets either directly via exchange-rate conversions of actual export and import prices or indirectly by exchange-rate conversions modified by various compensational adjustments such as tax rebates and subsidies. New prices based on these formulas were expected to provide enterprises with incentives to minimize costs of production and better adapt their product lines to demand in volatile export markets. In practice, the system quickly grew overly complicated, with widespread departures from the original principles, and it contributed little to cost-sensitivity or easing the country's current account imbalances. As some critics describe it: "Our price mechanism presupposes the market mechanism, and much of our problems are due to this fact or to the situation that in practice *we have a simulated rather than a real market.* We can expect an appropriate solution only if steps are taken to establish a *real market mechanism and competition.*" [3] (Emphasis added.)

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The new pricing reforms start out cautiously with applicability confined in 1984 mainly to an informally -designated "club of elite enterprises" representing the star performers in the manufacturing sector of industry. Firms eligible for membership in the club have unprecedented freedom to set their own prices, the only constraint being that their domestic prices cannot exceed the equivalent forint price of similar products imported from convertible currency countries. The firms also enjoy greater freedom in granting

[2] Since adoption of the New Economic Mechanism in 1968, reformers have looked on the economy as being composed of two broad sectors—the "competitive sphere" and the "noncompetitive sphere." The competitive sphere consists of sectors where a potential exists for "self-regulation" and includes the processing industries, the construction industry, and some services branches, together with domestic and foreign trade in products produced in these sectors. The concept implies a large number of producers and consumers of inputs and outputs competing with each other. The noncompetitive sphere includes agriculture and most infrastructure sectors that, in the interest of social policy and other national considerations, must be managed by the state. Agriculture in Hungary, despite substantial private activity, is largely under collective management and heavily subsidized by the state; subsidies keep the costs of production and retail prices of farm products below the levels that would prevail under free competition.

[3] Jozsef Berenyi and Mrs. Sandor Hole, "Experiences With the Price Mechanism," *Figyelo*, Budapest, 18 November 1981, p. 4

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Figure 3. Price reform—We adjust our prices to demand.

wage increases. Whereas other enterprises must pay a longstanding and steeply progressive tax on profits if they increase wages more than the 1984 5-percent limit, the more efficient "club" members are allowed to exceed substantially the 5-percent ceiling without having to pay the tax.

To be eligible for adopting the freer-pricing procedures, firms must be major exporters operating at a profit, and the demand and supply for their products must be subject to "adequate" competition in domestic markets. Requirements that the firms not hold monopolistic positions and that their products not be in short supply apparently are intended to forestall unjustified price hikes.

In 1984, the authorities expect some 60 to 100 enterprises, accounting for about a fourth of total sales in manufacturing, to adopt the new pricing formula. But the group of participating enterprises probably will expand rapidly, and the freer-pricing and wage-setting scheme is scheduled to become general in 1985 throughout much of industry, the construction trades, and a large part of the services sector. [4]

[4] Domestic prices of fuels and basic industrial materials will continue to be established according to the rules adopted in 1980; they are linked to the forint equivalent of import or export prices depending on whether Hungary is an importer to or exporter from the convertible currency area of the particular commodity. Prices of most other goods and services will remain under central determination, including basic consumer supplies, most agricultural procurement, and major areas of infrastructure such as housing and public health.

Other Related Measures. A major goal of the 1980 price reforms carried over in the new proposals is the establishment of a more rational relationship between producer and consumer prices. Reducing the former and increasing the latter would reduce the burden on the state budget of financing enormously costly price subsidies. 25X1

Solutions in this area require, in the first instance, a more frequent adjustment of the exchange rate based on fluctuations in international currency markets, since producer prices are based on world market prices. The National Bank of Hungary already adjusts the exchange rate of the forint on a weekly basis; the proposal is to make adjustments daily. This, in conjunction with enterprises' responsibility for making product mix and prices more competitive, will require that managers have access to more market-related information. 25X1

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No radical changes are contemplated in the determination of consumer prices, but the government plans to continue selective increases in prices of consumer goods and services. These increases will be constrained by the desire to maintain present living standards. Elimination of subsidies for certain essentials has been ruled out even over the longer term as being an unacceptable policy for a socialist state. 25X1

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The goal of reducing producer prices is complicated by the desire also to rationalize the relative input costs of labor, materials, and capital to enterprises. This goal would be accomplished primarily by increasing the costs to producers of hoarding labor. To encourage managers to get rid of redundant labor, enterprise contributions to the social security system will be increased. In addition, enterprises are to receive greater tax relief in return for trimming their work force, with the savings to be used to raise wages of the remaining workers. This latter proposal arouses concern, however, that enterprise managers will resort to the longstanding practice of passing on any increased costs in the form of higher producer prices. The freer price-setting scheme and more flexible interest rate policy being introduced this year should help make the costs of materials and capital more realistic. 25X1

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Figure 4. Inflation—Reducing Device: The National Price Office.

Figure 5. Bankruptcy—The weeping man represents a successful enterprise whose profits are being siphoned off to sustain another firm operating at a loss.

Taxation

Tax reform, because of its direct impact on both managerial and individual incentives, has posed a dilemma for the authorities right from the start of the New Economic Mechanism. On the one hand, reformers want to restructure the tax schedule so as to provide greater differentiation in enterprise profits and individual earnings based on productivity. The most productive enterprises and workers need to be rewarded for their efficiency and not see their earnings skimmed away to support laggards elsewhere in the economy. Yet, these earnings are the principal source of revenue needed to finance state expenditures. [redacted]

Because of the conflicting objectives, proposals for tax reform seem the most tentative. Their general goal is to lessen the burden on enterprises subject to heavy profits taxes while broadening the base of taxes paid by individuals. The issue apparently turns on the question of whether tax reform should be shaped more in the direction of the West European system of an indirect value-added tax or the American system of direct taxes on enterprise and personal incomes. We believe the Hungarians will make progress in this area, but the results most likely will not be evident before the end of this decade. [redacted]

Timetable and Obstacles

In essence, the reform proposals aim at considerably expanded use of market signals by providing more flexible formation of all price instruments—prices of goods, labor, capital, and credit. This would not accomplish full-fledged "market socialism" but it could propel the economic mechanism substantially further in that direction. Much remains to be done, however, in working out details and a more specific timetable for implementation. [redacted] 25X1

Even if government experts succeed in getting a revised outline approved by the Central Committee, which we expect will be convened for this purpose sometime next year, debates over details are bound to continue. As the proposals now stand, relatively small changes are planned for 1984-85, with the greater part of the package scheduled for introduction by stages during the next five-year plan (1986-90). [redacted] 25X1

A recent sampling of views among the Hungarian experts involved suggests that the major thrust through 1985 will be on reforms in enterprise management, pricing, and wages but that major changes in banking and taxation must wait until 1986-90. Reforms actually implemented down the line, furthermore, may differ markedly from what is agreed to in the short run. As of now, it appears that the New Economic Mechanism is passing through a new watershed that promises to keep it the most attractive model for significant evolutionary change in Eastern Europe. [redacted] 25X1

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Tax Reform

Under existing regulations, most producer enterprises pay a flat but stiff tax on profits to the state budget and a smaller one to local governments. They also are subject to a progressive tax on wage increases above a prescribed limit and a payroll tax to help fund social security. Trade and other firms that sell directly to the public pay additional consumer turnover taxes. The system has been changed several times since 1968, but still is cumbersome and complex. New proposals, still to be agreed upon, would reduce enterprise profits taxes by gradually eliminating the progressive tax and shifting more of the general incidence of the flat tax from primary and intermediate products to final goods. Adoption of a value-added tax, it is thought, would accomplish the latter goal and have the extra benefit of promoting exports in a way that would be acceptable to GATT and other international financial institutions.

At present, the only direct tax on personal incomes in Hungary is paid by private craftsmen and merchants, self-employed professionals, and persons working private farm plots or renting out private housing, with different tax schedules for each group. Employees of state enterprises and cooperatives pay only a pension contribution to the social security system administered through the state budget. This lack of uniformity—plus the growth of "second economy" workers enjoying untaxed incomes from part-time, after-work jobs, and the recent authorization of small-scale private and semiprivate enterprises—has led to a proposal for an integrated progressive tax that applies to all individual earnings from whatever source. For both technical and political reasons, however, the proposal is vague and states that even if a new type of personal income tax is accepted it can only be introduced gradually.

The key question is how far the Hungarian leadership is willing to go. For one thing, the proposals we have seen have the potential, at least in the short run, for upsetting the Kadar regime's commitment to improving living standards for the Hungarian people. While the typical Hungarian consumer remains better off than most of his counterparts throughout the Bloc, the regime, nonetheless, knows there are limits to the amount of austerity consumers will tolerate. The reforms also would force change on entrenched Party and government bureaucracies. Some bureaucrats almost certainly feel threatened by job losses resulting from an extensive decentralization. Others doubtless are reluctant to take the kinds of risks essential to making Hungary competitive in hard currency markets. 25X1

Finally, the reform proposals risk negative reactions not only from the new Soviet leadership but also from other East European governments, which are already wary of the demonstration effect of Hungary's higher living standards and are concerned that Hungary is moving too much on its own to improve relations with the West. Perhaps most worrisome for Hungary's CEMA partners is the fact that in the minds of many Hungarians the economic reforms are only the prelude to more fundamental changes. Budapest's economic proposals have been worked on not only by economists but also by sociologists, jurists, and historians who believe that an efficiently functioning market-oriented economy cannot succeed without significant political liberalization. Thinly veiled criticism of Hungary has already surfaced in Czechoslovak and Soviet news media chastising socialist countries that overestimate their own "model" and seek unilateral advantages from the West. Possibly in reaction to this kind of criticism, a Hungarian banker claiming to speak for party and government leaders has stressed to US Embassy officials the hope that Western officials and press commentary will not overplay the new reforms. Indeed, we would not be surprised if Budapest becomes very cautious in publicizing the details simply to avoid the problems with its Bloc neighbors that the Western press has helped create.

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In our judgment, Hungary is not going and does not intend to "go capitalist," as the Western media like to suggest. This would imply that the Communist Party is willing to abdicate its control over economic policy, enterprise behavior, and public welfare. Despite the novel and evolutionary nature of Hungary's economic policies, nothing we have seen suggests that the state is willing to relinquish ownership of the means of production, to cede real power to workers over enterprise management, or to embrace political pluralism at the national level. 25X1

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Appendix

Small Enterprises and the "Second Economy"[5]

Hungary has long tolerated private enterprise in agriculture and, to a lesser extent, in retail trade and consumer services. Since 1981 the Kadar regime has further legitimized and thereby spurred an increasingly wide range of activities in Hungary's huge "second economy" in a bid to ease some of the country's economic ills. We believe the Hungarian regime has come to appreciate that private market activity provides essential goods and services, supplements personal incomes during a period of austerity, and promotes a risk-taking entrepreneurial spirit lacking in the large, monopolistic, and grossly inefficient state and cooperative enterprises. Budapest has concluded that some enlargement of the legal private sector need not undermine its socialist principles and that legalization should strengthen its ability to record and tax the vast volume of economic activity going on outside the socialized sectors.

The Image of Capitalism

The regulations expanding the scope of authorized private enterprise unleashed a flurry of reports in the Western media that Hungary was "going capitalist" and probably raised some doubts among Budapest's more orthodox CEMA partners. In 1983 party Chief Janos Kadar stressed that the new measures had nothing to do with capitalist methods and emphasized that 98 percent of the means of production in Hungary remains socialized property. Kadar also stated that, whereas private activity accounted for 14 percent of agricultural production in 1982, it contributed only 1 percent in industry. Although Kadar's numbers roughly portrayed the situation in 1982, they do not fully reflect the importance of the second economy in delivering some key goods and services nor the momentum of the small enterprise program.

The Second Economy. Estimates by Hungarian researchers of the size of the second economy of legal, semilegal, and illegal private activities show:

- Three families in four in Hungary's population of 10.7 million enjoy a "secondary" income in addition to that received from state or cooperative services.

- Roughly half the population, including urbanites, cultivate private plots full or part time, making agriculture the largest employer in the private sector; for some food items—pork, eggs, potatoes, vegetables, and fruit—private agriculture is the primary supplier.

- The second economy also supplies the bulk of workers in housing construction, maintenance, repair, and other consumer services.

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Small Enterprises. Partial statistics indicate that by mid-1983 some 13,400 new small enterprises had been established, primarily in the industrial, construction, and service trades (see table). Employment in these ventures totaled only about 81,000 persons, partly because the regulations limit the permissible number of entrepreneurs and employees per enterprise. If legally licensed private craftsmen and retail merchants are added, the number of persons working full or part time in small enterprises comes to 243,000, or roughly 5 percent of the labor force.

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Some examples illustrate the kind of sanctioned activity allowing private entrepreneurs to seek out opportunities complementing—and, in some cases, competing with—the much larger state and cooperative enterprises:

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- A small advertising agency operating as a subsidiary of a state-owned corporation and designed to serve the needs of private entrepreneurs.

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Hungary: Estimated Number of Units and Employees in New Small Ventures as of Mid-1983 [a]

	Units	Employees
Total	**13,425**	**81,265**
Socialist sector		
Small state enterprises	100	NA
Subsidiary enterprises	70	NA
Small cooperatives	155	NA
Semiprivate sector		
Business partnerships within socialist enterprises	5,862	52,831
Specialized work units within cooperatives:		
In agriculture [b]	2,688	NA
In industry and services	660	NA
Private sector		
Private business partnerships	3,481	NA [c]
Civil law partnerships	409	NA

[a] Our grouping of the units into socialist, semiprivate, and private sectors is provisional. Small ventures in the "semiprivate" sector are hybrids that seem to be neither purely socialist nor purely private enterprises.
[b] In agricultural producer cooperatives and state farms.
[c] Although documentation is lacking, press commentary makes it clear that private business partnerships are the second-largest employers among small ventures.

- Eight small cooperatives and 33 semiprivate business partnerships in a large state automotive enterprise that handle tool design, toolmaking, machinery design, and some transport tasks.
- A private business partnership of professional mountain guides, called Sub-Alps, doing high rise repair work on state hotels.
- A two-person automotive repair service, named Non-Stop, which operates during the hours when state facilities are closed.
- Private taxi services, which for a fee can use state garage and service facilities and the VHF radio system.
- A private partnership producing small computers for hospitals.

We have not seen any figures suggesting the volume of previously semilegal or illegal activity that has been absorbed by the new small enterprise program. We suspect, however, that the bulk of unlicensed private entrepreneurs have adopted a wary, wait-and-see attitude. 25X1

Climate for Expansion

The regime has been gradually reducing obstacles to rapid expansion of the small enterprise program. These impediments—excessively high taxes, limited provision for loan capital, and cumbersome legal restrictions—were probably introduced deliberately at the outset to gain policy consensus, especially among ideological hardliners suspicious of any "private" inroads into the socialist system. As the program has unfolded, official policies toward these constraints have eased. 25X1

Official thinking seems ambiguous on how far legalized semiprivate and private activities should be pushed. Prospects for the program are difficult to discern. Little information exists on how many second-economy entrepreneurs have converted to legal status and the extent to which roadblocks are being created by large state and cooperative enterprises who view the changes as threatening. 25X1

There are good reasons why second-economy entrepreneurs appear to have made no headlong rush to register as legal enterprises. Apart from the high taxes they face when successful, these people are being invited to exchange the risk of arrest for the risk of policy shifts that might destroy their business. Only a consistent attitude by the authorities will gradually dispel such fears and suspicions. 25X1

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Since there are limits beyond which the government does not want small semiprivate and private ventures to grow, the large enterprises have little to fear in terms of serious competition for either labor or market shares. Nonetheless, these small ventures still could prove troublesome in other ways. In the case of labor, complaints have been voiced that young workers with above-average talent will switch their careers from state to higher paying jobs in the small ventures—threatening a "brain drain" from state enterprises. Perhaps even more unpleasant is the prospect that the small ventures, in their search for gaps in the market and under pressure to excel because of competitive risks, will further demonstrate the inefficiency of many large enterprises. 25X1

The program is vulnerable to criticism for contributing to a more unequal distribution of income and is arousing resentment among those unable or unwilling to become private entrepreneurs. Workers in a steel mill, for example, even if they could acquire the necessary capital, generally have neither the education nor skills in demand for legalized moonlighting. In the first half of last year, the purchasing power of a worker earning only regular wages declined more than 5 percent, whereas incomes for participants in the second economy continued to far outpace the country's 8.5-percent rate of inflation. 25X1

Expansion of legalized private activity may also be complicating the economic stabilization program Budapest worked out with the International Monetary Fund to help it through its financial difficulties. In its assessment of the 1983 program, the Fund noted that the rapid expansion of income in the private sector was a major factor preventing the reduction in domestic demand needed to improve Hungary's current account balance. While the IMF probably sees merit in legalizing second-economy activity as a means of helping to prevent a serious decline in living standards, it apparently has been pressing the regime to further boost—rather than reduce—taxes on large incomes. 25X1

At this stage, we believe the regime still sees more benefits than drawbacks to broadening the scope of legalized private enterprise. Thus, we expect a steady but measured evolution of the small venture program. If the government sticks with it over the next decade, Hungary will stand in even sharper contrast to its less imaginative, hidebound CEMA partners. A "socialist" economy with ownership shared among state, cooperative, semiprivate, and private enterprises would constitute a challenging model for emulation—particularly if it succeeds in promoting the efficiency that has eluded centrally planned economies and avoids creating pressures for parallel political reform.

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